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SUBJECT: ARGENTINA ECONOMIC AND FINANCIAL REVIEW, MARCH 17
- APRIL 4, 2008

¶1. (U) Provided below is Embassy Buenos Aires' Economic and Financial Review covering the period March 17 - April 4,
¶2008. The unclassified email version of this report includes tables and charts tracking Argentine economic developments. Contact Econoff Chris Landberg at landbergca@state.gov to be included on the email distribution list. This document is sensitive but unclassified. It should not be disseminated outside of USG channels or in any public forum without the written concurrence of the originator. It should not be posted on the internet.

Highlights

-- Economic Impact of Agricultural Sector Strike
-- GoA soon to issue ARP 1-2 billion of peso denominated debt
-- GoA considers debt exchange to alleviate 2009-2011 debt service payments
-- Who holds GoA defaulted debt?
-- What is going on with the Real Exchange Rate in Argentina?
-- FIEL criticizes quality of GoA primary fiscal surplus

Economic Impact of Agricultural Sector Strike

¶2. (SBU) Many local observers considered the farming sector strike that began March 13 -- in response to the GoA's unanticipated March 11 decree to increase export taxes on Argentina's major agricultural export crops --to be the worst crisis of the Kirchner era (since 2003). It was also seen as a major challenge to the Kirchner's Peronist economic model of taxing the most-productive sectors of the economy (mainly Agriculture) to support less efficient industry and create a social safety net for the roughly 25% of the population that lives below the poverty line.

¶3. (SBU) Post has sent in extensive front-channel reporting on the ongoing crisis -- which ended April 2 when farmers agreed to a 30-day truce -- with a particular focus on the political repercussions of the dispute. (See BA 368, 376, 398, 408 and 415). The impact of the 20-day strike on Argentina's economy and the GoA's budget is less clear at this time, but there is much to worry about. Local media is speculating that the cost of the strike so far -- on industry, transport, and commerce -- is as high as US$ 1.5bn, in the range of 0.5% of GDP (more than the US$1.2 billion in expected revenues from the March 11 tax increase). As a consequence, many analysts are considering lowering their forecasts for real GDP growth in 2008 (most current forecasts range from 6-7%).

¶4. (SBU) While the strike's blockade of the nation's transport infrastructure had a direct effect on a number of

industrial and commercial sectors, of equal concern to analysts are the measures the GoA announced March 31 to alleviate the impact of the higher taxes on small and medium-size farms. The worry is that these mostly fiscal incentives could adversely impact the GoA's finances, leading to further uncertainties about the GoA's financing needs, interest rates, and stability of the peso. (Export tax revenues account for over 80% of the primary fiscal surplus.)

¶5. (SBU) Higher subsidies, reduced tax collection due to the cessation of cereals and grains exports, and the overall adverse impact of the strike on the economy (and on tax collection), have led many private analysts to reduce forecasts for the GoA's primary fiscal surplus for 2008, after having just increased them following the March 11 tax increase. Early reports on March tax collection show that it was much lower than expected, due in large part to the double blow the GoA received on soy export taxes: soybean prices have fallen significantly (nearly 25%) off their high, and because of the protests only about 5% of Argentine soybeans have been harvested, compared to about 20% standard for this point in the harvest season.

¶6. (SBU) Also of increasing concern is the possible spike in inflation due to strike-related food price increases, with some estimates for year-end inflation as high as 40% (although most are in the 25-30% range). Analysts are also closely watching the peso, which has depreciated slightly against the dollar (during a period when it usually appreciates due to large FX inflows from Ag exports). There is worry that the GoA may consider offsetting lost tax revenues with a depreciation of the peso. This scenario could provoke capital outflows, leading to interest rate hikes, decelerating consumption and imports, lower tax

revenues, and increasing uncertainties about the GoA's finances. No doubt due to the increased pessimism resulting from these added uncertainties, Argentina's country risk rating, as measured by JPMorgan's EMBI plus reached 581 basis points, near the post-default high, its Credit Default Swaps rate jumped up to a record 594 basis points, and local think tank Ecolatina's "Financial Risk Index" (which also measures peso bonds) closed at a new record of 785 basis points.

¶7. (SBU) The question is whether this strike is a political and economic turning point. Whether or not the GoA reacts by improving its political and economic decision-making, this strike may still result in a weakened government and economy, leaving Argentina more vulnerable to and unprepared for a sharp downturn in global commodity prices.

GoA issues ARP 867 million peso bonds at a yield of 13.30%

¶8. (SBU) In an April 3 auction, the GoA issued ARP 867 million of Bonar 2013 (Bono de la Nacion) at a yield of 13.30%, below market expectations of 13.5%-14%. This is a peso-denominated, variable rate, 5-year bullet bond, maturing in 2013, with an interest rate of BADLAR plus 350 basis points. (The Badlar, currently at 8.5%, is the wholesale interest rate for deposits of more than ARP 1 million (approx. $320,000).) The GoA last issued a 5-year, eso-denominated, fixed rate bullet bond in June 2007 (without inflation adjustment) at a yield of 11.70%.

¶9. (SBU) The GoA is authorized to issue up to ARP 5 billion ($1.6bn) of this bond. It received bids for ARP 1.8 billion, resulting in a bid cover ratio of 2.1, and raised ARP 827 million cash value (as the bond was issued at a discount). Local media had speculated that the success of this first issue was guaranteed, despite international market turbulence, because of strong appetite from local investors, especially pension funds, banks, and insurance companies. The pension funds' high liquidity positions are due to: a) the increase from 7% to 11% in employee wage deductions for

pension contributions; and b) the GoA regulation, issued October 2007, forcing Argentine pension funds to repatriate their investments from Mercosur countries (primarily Brazil). However, when analyzing the bids for the auction, it is clear that the success of this issue was due to Banco la Nacion's strong participation, as it purchased 42% (or ARP 365 million) of the issue. According to local traders, without Banco Nacion's participation, the bond yield would have exceeded 14%. Ambito Financiero speculated that if the GoA had issued a fixed rate bond, similar to the one issued June 2007, it would be paying a 16% fixed interest rate.

¶10. (SBU) For reference, November 2007 was the last time the GoA was able to issue bonds at public auction, and it issued $500 million of the Bonar X (ten-year, dollar denominated bond, maturing April 2017, with a 7% fixed interest coupon, at a yield of 10.5%). Thereafter, the GoA completed its 2007 financial needs by issuing debt directly to public sector agencies, such as the Social Security Administration, the Argentine tax collection agency (AFIP), and the Federal Lottery. GoA financial needs in 2008 are estimated at $6 billion, and the GoA hints that it intends to raise $4 billion from public sector agencies (and possibly from the Venezuelan government) and $2 billion through local auctions, taking advantage of the strong local liquidity. So far this year, the GoA has issued ARP 1.9 billion of short-term debt (with a maturity of 6 to 12 months), exclusively to public sector agencies.

GoA considers debt exchange to alleviate 2009-2011 debt service payments
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¶11. (SBU) On March 12, Cronista Comercial reported that the GoA is analyzing the launch of a debt exchange to lower GoA debt principal and interest payments over the next four years (especially 2009-2011, during which GoA debt obligations peak). The secondary motive is to extend the GoA debt yield curve. Cronista reports that the GoA would like to complete the mini-exchange during the first half of the year, if market conditions allow it. Although GoA officials declined to confirm this transaction to Cronista, Economy Ministry officials have confirmed on numerous occasions to Post's EconOffs that the GoA wants and needs to do this by mid-year. Details of the transaction:

-- Eligible bonds: mainly Guaranteed Loans with large maturities (both interest and principal) concentrated in 2009-2011 and totaling $8.6 billion. (Note: Payment is

guaranteed by tax collection. The GoA issued them in November 2001 as part of a "voluntary" debt exchange, intended to extend maturities and reduce interest payments. These loans continued making interest and principal payments despite the 2001 default. Originally dollar-denominated, these bonds were pesified and linked to inflation in January 2002.) Also, the GoA may include dollar-denominated Bodens maturing in 2012 and 2013, with total debt service payments of $8.8 billion due between 2009 and 2011. (Note: Bodens were originally issued after the 2001 default in a swap for reprogrammed bank deposits trapped by the corralito or corralon, and to banks in compensation for asymmetrical pesification. However, afterwards, the GoA continued issuing Bodens for financing purposes.)

-- New bonds: Local media speculate that the new dollar-denominated bonds (presumably to be exchanged for the USD Bodens) would have a maturity of 5-10 years, while the peso-denominated bonds (to be exchanged for the guaranteed loans) would have a variable interest rate (based on the Badlar rate, currently at 8.5%) and no inflation adjustment. Many investors may find the exchange of guaranteed loans attractive since it would enable them to exchange an illiquid (not tradable) instrument for a tradable one.

Who holds GoA defaulted debt?

¶12. (SBU) Determining who holds the $28 billion in so-called "holdout" debt -- GoA defaulted debt that was not tendered in the 2005 GoA debt restructuring -- is more art than science, since defaulted debt is still being traded. Currently, most of the untendered debt quotes at 32-35 cents on the dollar. It is interesting to note that:

-- As of the third quarter of 2007, GoA untendered debt totaled $28 billion, of which 29% ($8.3 billion) has not yet matured. Of the remaining 71% ($19.8 billion) that has already matured, there is $11.7 billion in principal arrears and $8.0 billion in interest arrears.

-- Most holdout debt is in foreign currency (98% of total, or $27.4 billion) and issued under international law (also 98% of total). Peso and Argentine law holdout debt (with and without CER) CPI linked index) totals only about $650 million. See below detailed table with the split between arrears and unmatured debt.

-- Of the $27.4 billion holdout debt denominated in foreign currency (non-ARP), 38% ($10.4 billion) is USD denominated and 61% ($16.7 billion) is in EUR denominated. The remaining 1% ($176 million) is JPY denominated. There is a negligible amount denominated in Swiss Franks (CHF) and British Pounds (GPB).

-- According to American Task Force Argentina (AFTA), Americans hold $3.0 billion, or 11% of GoA holdout debt and almost 30% of dollar-denominated holdout debt.

What is going on with the Real Exchange Rate in Argentina?
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¶13. (SBU) A depreciated Real Exchange Rate (RER) has been a key element of GoA economic policy since the 2002 crisis and devaluation, and, the GoA asserts, a foundation of Argentina's high export growth in recent years. In Argentina, the RER was relatively "low" during the 1990s, undermining the manufacturing sector. In contrast, the 2002 devaluation fueled domestic production of industrial goods and commodities. In particular, in the case of agricultural commodities, the devaluation was complemented by: 1) Argentina's comparative advantages in these goods; 2) record-high international demand; and 3) the resulting run-up in global commodity prices. Although the exchange regime is officially "flexible," since April 2003 the GoA and Central Bank's exchange rate policy objective has been to prevent the nominal appreciation of the peso, in order to protect domestic industry.

¶14. (SBU) Local media reports that on March 11 representatives of UIA (Argentine Industrial Association), the country's leading industrial association, met with President Cristina Fernandez de Kirchner and Economic Minister Martin Lousteau to discuss the energy crisis and the loss of local industry's competitiveness as a result of a declining RER (i.e., a real appreciation of the peso). UIA said their competitiveness in international markets was being undermined by the relatively stable nominal exchange rate (at around 3.15 ARP/USD), coupled with increasing domestic

industrial salaries and higher costs in general (due to the annual inflation of approximately 20%). The press speculated that the UIA was pushing the GoA to devalue the peso.

¶15. (SBU) With actual inflation of over 20% (compared to official inflation of 8.5% in 2007), the Central Bank's informally fixed peg to the dollar is resulting in a real appreciation of the peso. Although the RER against the dollar (i.e., the purchasing power of the pesos needed to buy one dollar in Argentina) is relatively stable when using official inflation numbers, when using independent measures of inflation, the RER would have been falling (i.e., the peso appreciating). However, this gives an incomplete picture,

since Argentina has a diversified export profile and trades with many countries in the world. Brazil represented 19% of Argentine exports in 2007, followed by the EU (18%), China (9%), Chile (7%), and the U.S. (7%). So, from a trading perspective, the roles of the Euro and the Real are more relevant than the role of the dollar. Since most of Argentina's trading partners' currencies have appreciated significantly against the dollar in recent years, Argentina's multilateral RER has stayed relatively stable, despite high inflation. The Central Bank's estimate of the multilateral RER for Argentina's main trading partners, using the official inflation rate, shows the peso depreciating. Even using much higher independent inflation estimates, the multilateral RER is relatively stable or appreciating slightly.

FIEL criticizes quality of GoA primary fiscal surplus
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¶16. (SBU) Buenos Aires-based Latin American Economic Foundation -- FIEL -- reports that Argentina's fiscal primary surpluses in recent years have arisen from extraordinary circumstances, with the implication that the GoA would not enjoy such sound finances were it to follow more traditional tax policies and global commodity prices were closer to their long-term averages. (Note: FIEL is a highly regarded, independent Argentine think tank devoted to economic and social research on Argentina and Latin America.)

¶17. (SBU) FIEL contrasts the GoA's conventional fiscal primary with its estimated "structural" primary surplus, which estimates revenues based on three-year moving averages for international commodity prices and local export taxes, a financial transaction tax following the traditional Brazilian rate of 0.38%, rather than the Argentine tax of 1.2%, and also eliminates one-off transfers such as the $2.5 billion transferred from the private pension funds system to the GoA in 2007. FIEL analysis delivers a fiscal primary deficit of around 0.5% of GDP for 2007 and 0.6% for 2008, even considering that public expenditure growth has slowed to a nominal annual rate of 36% so far in 2008, compared to the over 50% expenditure growth rate in 2007. (Note: the actual primary surplus was 3.2% of GDP in 2007 including one-off transfers, or 2.2% excluding them, and private estimates for 2008 range from 3.5 to 4% of GDP, depending on revenue collection from export taxes.)
WAYNE